

The external balance sheet of the United Kingdom: recent developments

This article examines changes to the net external asset position of the United Kingdom during 1993 (using figures published in the 1994 CSO Pink Book). It focuses on changes in the pattern of capital flows during the year and on the impact of valuation changes to existing assets, and includes an international comparison of external balance sheets.

Introduction

The United Kingdom had net external assets of £20.3 billion at the end of 1993, compared with a revised balance of £10.6 billion at the end of 1992. This increase in net external assets was achieved despite a current account deficit and reflected a positive revaluation of UK net assets, largely the result of asset price movements (see Table A). The net asset position (the balance of gross stocks of assets and liabilities of over £1.3 trillion) is, however, subject to revisions—as illustrated by the £16 billion downward revision to the 1992 figure since the 1993 Pink Book.

Table A
UK external assets and liabilities^(a)

£ billions	Stock end-1992	Identified capital flows	Net valuation effect (b)	Total change in stock	Stock end-1993
Non-bank portfolio investment:					
Assets	227.2	50.0	33.1	83.0	310.2
Liabilities	140.5	24.1	20.6	44.7	185.2
Direct investment: (c)					
Assets	143.7	17.3	5.2	22.5	166.2
Liabilities	121.8	9.5	-0.4	9.1	130.9
UK banks' (d)(e) net liabilities in:					
Foreign currency	14.3	3.7	-7.2	-3.5	10.9
Sterling	32.4	-8.2	-0.7	-8.9	23.5
Public sector					
Reserves (assets)	27.9	0.7	1.2	1.9	29.8
British government stocks (liabilities)	28.8	13.4	4.7	18.1	46.9
Other net public sector assets	-5.3	2.4	-0.4	2.0	-3.4
Other net assets	-45.0	-36.2	-4.0	-40.2	-85.2
Total net assets	10.6	-8.3	18.0	9.6	20.3

(a) The sign convention is not the same as in the balance of payments: a transaction that increases an itemised stock is + and one that decreases it is -.

(b) Residual component.

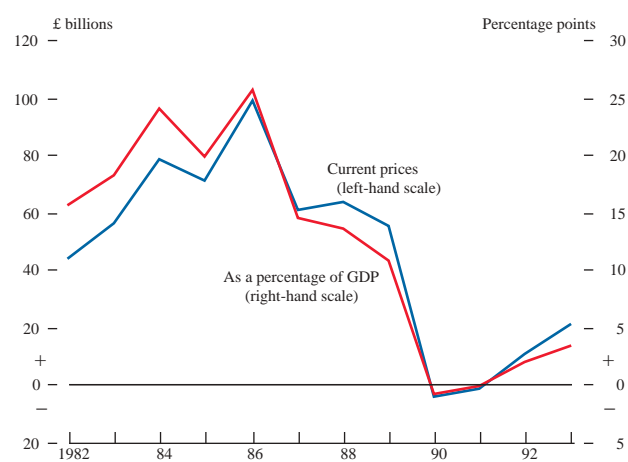
(c) UK banks' external borrowing from overseas affiliates is treated in the published data as an offset to outward direct investment, but it is treated here as part of the banks' net foreign currency liabilities.

(d) Estimated take-up of UK banks' bonds appears indistinguishably from foreign investment in other UK company subsidiaries in the published data, but is treated here as part of banks' net foreign currency liabilities. Banks' holdings of foreign currency bonds are treated as foreign currency lending.

(e) UK monetary sector plus certain other financial institutions.

Net capital inflows totalled £8.3 billion in 1993. There were massive inward and outward portfolio investment transactions during the year. The record purchases of overseas securities by UK residents (mainly banks and securities dealers), which seem to have been financed mainly by foreign currency borrowing from overseas, were subject to significant revaluations largely as a result of price

Chart 1
Net identified external assets at current prices and as a percentage of annual GDP



increases. The increased holdings of securities also provided additional interest and dividend receipts which contributed to net investment earnings of £3.1 billion in 1993, down on 1992's £4.3 billion of earnings.

Capital flows

The United Kingdom's capital account transactions in 1993 were dominated by activity in the securities markets. Both net outward and net inward portfolio investments were at record levels—at £85 billion and £40 billion respectively. Gross turnover also soared. Banks reported a threefold average increase in their own transactions in overseas bonds between 1992 and 1993.

Balance of payments data can offer only limited insights into the intentions of investors, because they record flows which in the event establish equilibrating exchange rates and asset prices in the market. But a number of features of market conditions may have contributed to the scale of activity.

First, as both market and official short-term interest rates fell, investors sought ways to improve returns. The higher returns available from longer-term maturities proved attractive, and this encouraged securities markets' activity. Second, there was a sharp increase in borrowing by sovereign authorities—both to fund government deficits and to replenish foreign exchange reserves in the wake of the

intervention within the European exchange rate mechanism. Around \$45 billion worth of international foreign currency bonds were issued by European governments in the first half of 1993, and \$28 billion in the second half. These high-quality sovereign bonds with a zero capital adequacy weighting were particularly attractive to banks, which were generally facing weak loan demand. The need of a number of governments—particularly in Europe—to sell high volumes of debt also encouraged them to introduce changes to their instruments and markets to make them more attractive to international investors.

Given London's importance as an international financial centre, both its banks and securities dealers—in their role as financial intermediaries—benefited from the active financial markets. Banks' fee income from overseas for securities transactions, for instance, increased by 50% in 1993 to £280 million.

Banks and securities dealers recorded sharp increases in their net purchases of overseas securities, particularly bonds. Banks purchased £34 billion of bonds and securities dealers £39 billion—both threefold increases on the previous annual records. This surge in portfolio investment was associated with a sharp increase in their net short-term borrowing. In total, UK residents—mainly banks and securities dealers—borrowed around a net £60 billion from overseas in 1993, easily a record (see Table B).⁽¹⁾ This suggests that the portfolios of both banks and securities dealers were at least in part financed by short-term borrowing.

Table B
UK balance of payments: transactions data

£ billions	1989	1990	1991	1992	1993
Increase in UK assets (-)/increase in UK liabilities (+)					
Current balance	-22.5	-19.0	-8.2	-9.8	-10.3
Long-term capital:					
Public sector (a)	-3.4	-0.6	7.0	7.7	14.6
Private sector (b)	-21.3	3.2	-19.0	-13.8	-68.0
	-24.7	2.5	-12.0	-6.1	-53.5
Balance	-47.2	-16.5	-20.1	-15.9	-63.8
Short-term capital (c)	22.4	8.4	13.7	13.1	33.7
Banks' transactions (d)	16.4	7.3	9.6	-5.0	28.8
Balance before reserves and errors	-8.3	-0.7	3.1	-7.9	-1.3
Reserves	5.4	-0.1	-2.7	1.4	-0.7
Errors and omissions	-2.9	-0.8	0.4	-6.5	-2.0

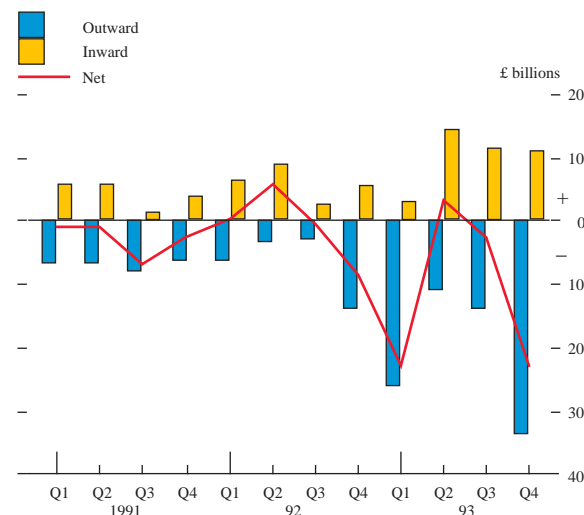
Columns may not sum to totals because of rounding.

- (a) Includes overseas purchases of gilts and long-term government borrowing.
 (b) Includes direct and portfolio investment excluding overseas investment in gilts.
 (c) Includes all non-bank and government capital flows other than long term as defined above.
 (d) Banks' net deposits, ie excludes banks' portfolio direct investment.

Foreign-owned securities dealers appear to have financed some of their investment by borrowing from their overseas parents, including through repurchase agreements. The existence of a positive yield curve—particularly in dollars, but also in sterling—made such transactions attractive,

especially combined with an expectation that short-term interest rates would remain low (in the case of US rates) or fall (in the case of European rates). The market corrections in February this year followed the rise in US short-term interest rates and were associated, in the UK balance of payments accounts, with a sharp reversal of investment flows.

Chart 2
Portfolio investment^(a)



(a) Includes banks' investment. + = increase in liabilities.

In contrast to banks and securities dealers, life assurance and pension funds concentrated their overseas securities investment in equities. But outward investment in equities, although strong at £8 billion, did not exceed the record years of 1989 and 1991. Instead institutional investors were heavy purchasers of UK securities.

Inward portfolio investment into the United Kingdom was also at record levels in 1993. The funding of the public sector borrowing requirement (PSBR) provided a steady supply of gilts during the year; and falling UK interest rates, a positive outlook for inflation and, for most of the year, a broadly stable exchange rate made gilts attractive to overseas investors, whose net purchases were a record £13 billion.

Overseas investors also made record net purchases of UK company securities (£25 billion). Companies took the opportunity of falling interest rates and rising share prices to raise funds in the securities—and particularly the equity—markets and repay bank borrowing.⁽²⁾ And they responded to the strong rally in fixed-interest sterling markets by significantly altering the currency profile of their bond liabilities in favour of sterling fixed-rate bonds. In the year to the end of 1993, the outstanding proportion of sterling denominated fixed-rate to total UK corporate bonds increased from 17% to 23%. (By June this year, it had reached 26%.) In contrast, the proportion of yen and Swiss franc denominated bonds fell from 14% to 9%.

(1) Table B presents balance of payments data in a form that highlights the distinction between short and long-term capital. This form of presentation has not traditionally been used for the UK accounts but is common elsewhere, and is used by a number of countries eg Japan.

(2) More details on this can be found in the article on company profitability and finance in the August *Bulletin*, pages 241–9.

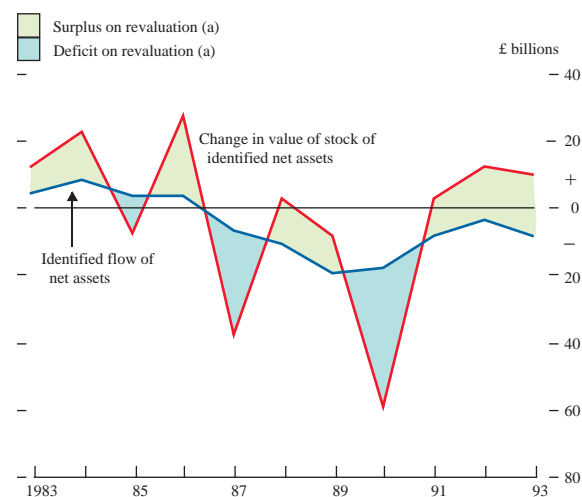
UK companies also raised capital in other markets. According to data collected by the Bank of England and included in the balance of payments statistics, UK companies raised a total of \$1.6 billion in the US markets, with American Depositary Receipts—a vehicle used to allow trading in overseas equities in the US markets—particularly prominent. This year, some companies have also issued equity securities on the National Association of Securities Dealers Automated Quotations (NASDAQ). UK companies were also significant issuers in the euromedium-term note (EMTN) market; 1993 was notable for the number of issues structured to the needs of investors using derivatives. According to data from the Bank of International Settlements, outstanding UK EMTN issues doubled to \$19.6 billion in the year to the end of 1993 (and reached \$28 billion by the end of June 1994).

The apparent recovery in inward direct investment capital flows reflected the recovery in the earnings of UK direct investment enterprises (see the section on investment income below) and the retention of a significant proportion of these earnings. By contrast, gross outflows of share and loan capital into direct investment enterprises were at their lowest since 1984, perhaps reflecting the corporate sector's focus on balance-sheet restructuring rather than expansion. Similarly, gross inflows were below those seen in recent years, when the development of the Single Market may have encouraged a surge of direct investment activity. Nonetheless, the trend—evident since 1990—of net inflows of share and loan capital continued.

Effects of revaluation and an international comparison of external balance sheets

A current account deficit has to be financed by net capital inflows. Other things being equal, these will reduce net external assets by a reduction in gross external assets, an increase in gross external liabilities or some combination of the two. Net external assets are, however, also affected by changes in the valuation of gross external assets and

Chart 3
Contributions to changes in net external assets



(a) Residual component—difference between change in recorded net stock and identified net flows.

liabilities. In 1993, revaluation effects of some £18 billion more than offset the negative impact of the £8 billion needed to finance the current account deficit. As a result, the United Kingdom's stock of net external assets rose to £20 billion.

Revaluation effects may be the result of changes in exchange rates or securities prices, or of other factors such as write-offs and revaluations of direct investment. It is difficult precisely to reflect the effect of changes in exchange rates and asset prices in the official statistics, and so there is an element of uncertainty in the estimate of the net asset position. Table C estimates the impact of revaluation factors and relates them to identified capital inflows. The estimate for the exchange rate revaluation effect is disaggregated into components for portfolio investment, direct investment and other net assets (lending to overseas residents and the effects on the official reserves and central government assets). Since precise figures are unavailable because of a lack of information about currencies of denomination and the types of investment involved, the estimates should be regarded only as indicative.

Table C
Change in identified net external assets

	Average (a)					
	1982–89	1990	1991	1992	1993	1994 H1
A Current balance (deficit -)	-4.1	-19.0	-8.2	-9.8	-10.3	-2.4 (b)
B Identified capital flows (inflows -) (c)	-1.9	-18.2	-8.6	-3.4	-8.3	-1.4
C Revaluations	4.7	-41.4	11.5	15.7	18.0	6.4
of which:						
Exchange rates		-20.8	10.3	45.6	4.0	1.8
Portfolio investment		-19.0	3.2	27.7	0.2	1.0
Direct investment		-14.2	6.4	27.6	3.0	2.7
Other net assets		12.4	0.7	-9.7	0.8	-1.9
Securities price effect		-14.1	9.9	-13.3	12.7	23.7
Other (d)		-6.5	-8.7	-16.5	1.3	-19.2
D Change in identified net assets (increase +)	2.8	-59.6	2.9	12.3	9.6	4.9
E Net asset level (end-year)	55.0	-4.6	-1.7	10.6	20.3	25.2 (e)
F Balancing item (f) (inflows/credits +)	2.3	0.8	-0.4	6.5	2.0	1.0

(a) End-year net asset level refers to end-1989.

(b) Seasonally adjusted.

(c) Note the difference between this sign convention and that of the balance of payments statistics.

(d) Including revaluations to direct investment stocks relating to write-offs, profitable disposals of assets etc as well as residual error.

(e) This is a preliminary estimate of the net stock position at the end of the second quarter of 1994.

(f) F=B-A.

Since 1990, when there was a negative effect of £41 billion, revaluation effects have been positive. Sterling's depreciation in 1992 following the suspension of ERM membership led to a very large positive revaluation of the sterling value of assets denominated in foreign currencies; in 1993, by contrast, the exchange rate revaluation effect was small because sterling's effective exchange rate was broadly unchanged between year-ends. In 1992, sterling's depreciation resulted in a £27.7 billion upward exchange rate revaluation of net portfolio investment assets. But the rally in sterling securities markets (particularly relative to overseas markets) following the suspension of ERM membership led to a negative price revaluation effect of £13.3 billion, as the value of UK gross liabilities held by

overseas residents increased by a larger amount than UK external assets. By contrast in 1993, the positive revaluation on portfolio investment of about £13 billion seems to have been almost wholly the result of changes in securities prices.

Preliminary estimates for the first half of this year indicate a £6.4 billion positive revaluation. Again the dominant factor was a positive securities price effect: this probably reflected the relatively sharp decline in UK sterling bond prices in the first half of 1994. The size of the effect, however, should be regarded with caution since the portfolio levels data may be subject to significant revisions. The exchange rate effects were in line with those in 1993, with a positive effect as a result of the slight depreciation of sterling over the first half of the year.

The net external asset positions of the United States, Japan, Germany and France—as well as the United Kingdom—are set out in Table D. Their different current account

Table D
International comparisons of external net asset positions^(a)

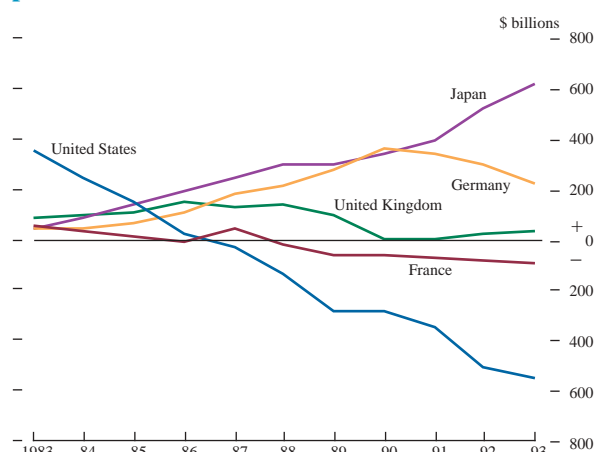
End-years	1981	1985	1990	1991	1992	1993
United States						
\$ billions	374.3	139.1	-291.9	-349.5	-507.9	-555.7
Percentage of GNP	12.3	3.4	-5.3	-6.1	-8.4	-8.7
Japan						
\$ billions	10.9	129.8	328.1	383.1	513.6	610.8
Percentage of GNP	1.0	10.0	10.3	10.6	13.7	14.4
Germany						
\$ billions	29.2	53.3	356.8	328.1	286.0	211.6
Percentage of GNP	4.0	9.0	21.8	18.7	16.5	13.0
France						
\$ billions	56.4	6.1	-71.2	-74.5	-89.0	-98.7
Percentage of GNP	11.6	1.0	-5.7	-5.8	-7.1	-8.3
United Kingdom						
\$ billions	62.2	104.0	-8.9	-3.2	16.0	30.1
Percentage of GNP	11.9	22.4	-0.8	-0.3	1.8	3.2

(a) The data underlying this table are taken from national sources, the IMF *International Financial Statistics Publication* and the *Financial Accounts of OECD countries: France*. National sources may use disparate methodologies.

performances and the effects of revaluations—mainly caused by exchange rate fluctuations—have led to a sharp divergence in their net external positions since the mid-1980s.

The fall in the value of Germany's net external asset position in recent years has been accompanied by its current account moving into deficit since 1991. The appreciation of the Deutsche Mark against the US dollar from 1988 onwards has further reduced its net external asset position. Unlike Germany, Japan—although its currency has also appreciated—has continued to run significant current account surpluses in recent years. As a result, whereas in 1990 its net asset position was broadly similar to Germany's, by the end of 1993 Japan's net assets were almost \$400 billion higher. US net external liabilities have continued to increase, as the current account has remained in deficit. And current account deficits between 1987 and 1991 have resulted in France's moving from a broadly neutral position in 1985 to having net liabilities of \$100 billion by the end of last year.

Chart 4
International comparisons of external net asset positions^(a)



(a) See footnote to Table D.

Investment income

UK net investment income earnings declined slightly in 1993 from the record figures in the previous year, but remained significantly above the position in the early 1990s. As Table E shows, the decline in net earnings was attributable to the performance of net direct investment earnings. Both inward and outward gross earnings rose in 1993, but the growth of inward earnings was larger. The earnings of foreign-owned enterprises in the United Kingdom increased as activity picked up; most notably, after four years of poor returns foreign-owned banks increased their earnings by £3.2 billion compared with 1992. This recovery was mainly the result of a fall in provisions against bad debts and of the favourable conditions in the capital markets. By contrast, UK-owned banks overseas recorded only mixed results, mainly because of subdued earnings in Europe.

Table E
Investment income (II)

	£ billions					
	Annual average 1982-89	1990	1991	1992	1993	1994 H1
Earnings on assets						
Portfolio (a)	2.6	4.7	5.5	8.3	9.9	5.1
Direct	9.5	15.6	12.8	13.3	16.7	9.8
Other non-bank private sector	1.8	3.8	4.3	4.0	4.8	2.5
Public sector (b)	1.1	1.8	1.8	1.6	1.4	0.9
UK banks' spread earnings on external lending	1.8	0.1	0.3	1.8	2.0	1.9
Total	16.7	26.0	24.7	29.0	34.8	20.2
Payments on liabilities						
Portfolio (a)	1.4	5.8	6.5	6.4	6.6	3.5
Direct	6.8	7.0	4.5	5.1	10.5	4.4
Other non-bank private sector	1.9	4.7	5.7	6.9	8.1	5.0
Public sector (c)	1.8	2.5	2.6	3.1	3.3	2.1
Banks' cost of net liabilities	1.5	5.0	5.6	3.2	3.2	0.8
Total	13.3	25.0	24.9	24.7	31.7	15.7
Net II earnings	3.4	1.0	-0.2	4.3	3.1	4.4 (d)
Net II excluding spread earnings	1.6	0.9	-0.5	2.5	1.1	2.5

(a) Non-bank private sector.
(b) Including official reserves.
(c) Including gilts.
(d) Not seasonally adjusted.

Banks' earnings from foreign exchange services to overseas residents

The importance of the foreign exchange market in the United Kingdom has been shown in surveys of foreign exchange turnover, most recently in 1992.⁽¹⁾ The Central Statistical Office (CSO) therefore asked the Bank to investigate the possibility of producing estimates of banks' foreign exchange service earnings consistent with IMF guidelines, for use in the current account of the balance of payments. The IMF guidelines, included in the fifth edition of its balance of payments manual (published in 1993), contain a recommendation that the spread between the midpoint and the buying or selling rate on foreign exchange transactions should be regarded as a service charge.

Until the end of 1991, banks provided data on their foreign exchange earnings from overseas residents (though these were not consistent with the new IMF guidelines). During the last Banking Statistics Review in 1990, however, bank representatives stressed the difficulties in estimating the split of earnings between overseas and UK residents, and hence the poor quality of the data provided. As a result, the split was not included in the new reporting form on balance of payments current account transactions introduced in 1992 (although data on explicit fees and commissions received from overseas residents for foreign exchange trading was included).

It was clear as a result that, to meet the IMF recommendation, the Bank would have to rely on information additional to that provided through the regular reporting system. It was decided to produce a benchmark estimate using the Bank's 1992 survey of foreign exchange turnover. As that survey was carried out in a month which the Bank for International Settlements (BIS)⁽²⁾ described as fairly normal on the exchanges, it was reasonable to apply an average spread

to the turnover data to produce a reliable estimate of service earnings. Deriving the benchmark estimate was still not straightforward, however: decisions had to be made about the type of business (spot and outright forward), the size of the spread (five basis points was settled on), and the type of counterparty (non-bank overseas residents) to include.

The results were highly sensitive to these decisions—particularly the exclusion of trading between UK banks and banks resident overseas. The BIS report stated that banks in smaller centres tend to hedge their positions in bigger centres; if so, banks in London are probably providing hedging services to other financial centres. Ideally, those services should be included in the estimate, but the banks contacted were unable to offer any indication about the scale of the activity. It is likely that including even a small proportion of this business would have significantly increased the estimates of service earnings; for that reason, the figures probably understate UK banks' foreign exchange service earnings from transactions with overseas residents.

The benchmark estimate suggested that, at £125 million, foreign exchange service earnings from overseas residents constituted around 30% of total bank earnings from foreign exchange dealings in the second quarter of 1992. In considering how to produce regular quarterly estimates, the Bank decided against simply applying a constant 30% factor to banks' total foreign exchange earnings, because research suggested that market volatility affected the relationship between service earnings and total earnings. Consequently, a quarterly standard deviation measure of exchange rate volatility for the major currencies was developed, which is taken into account when the quarterly estimates are produced.⁽³⁾

(1) See the article, 'The foreign exchange market in London,' in the November 1992 issue of the *Bulletin*.

(2) See the 'Central Bank Survey of Foreign Exchange Market Activity in April 1992', BIS Monetary and Economic Department, published March 1993.

(3) Copies of the full report produced for the CSO may be obtained by writing to the Balance of Payments Statistics Group, Monetary and Financial Statistics Division, Bank of England.

Total UK earnings on overseas direct investments once again benefited from robust economic growth in North America—the location of approximately 40% of UK direct investment.

There was an improvement in the net earnings of non-bank portfolio investments on the positive position in 1992. As the rate of return on assets was broadly unchanged between 1992 and 1993 (see Table F below), the higher gross earnings were the result of the massive build-up of holdings of overseas securities after the suspension of sterling's ERM membership. The rise in earnings was paralleled by higher payments on the 'other overseas liabilities' of the non-bank private sector, ie short-term borrowing abroad. The most significant element in this was increased payments by non-bank UK financial institutions and probably represented the financing of security positions. But even net of these

borrowing costs, portfolio earnings increased (by £0.4 billion).

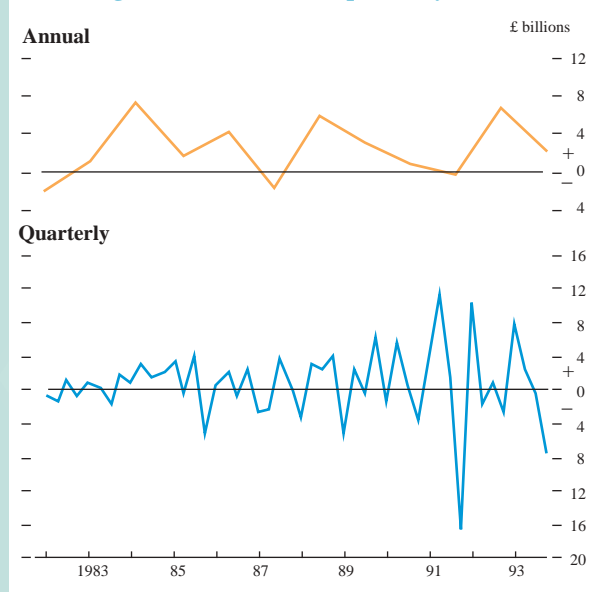
As in 1992, banking sector earnings contributed significantly to strong net investment income earnings in 1993. Banks recorded net interest and dividend receipts—rather than payments—for the first time since 1986. An important factor was a shift in the relative importance of the various sources of banks' overseas earnings—with securities income forming an increased proportion, reflecting the record purchases of overseas securities described above.

The benefit to banks' overseas earnings of their greater involvement in securities markets is illustrated in Chart 5, which shows their 'turn'—their investment earnings less their cost of funding. The data, based on a method developed within the Bank, were published in the British

Measurement issues

The 1994 CSO Pink Book included revisions to the data published a year earlier. The revisions to the current account deficits in 1990, 1991 and 1992 widened each by between £0.5 billion and £1.2 billion, in part because of improved estimates of the interest payable on overseas residents' holdings of gilts. The net asset position at end-1992 was revised down by £16 billion to £10 billion. And the net statistical discrepancy in 1992 was increased from under £1 billion to £6.5 billion. Although larger than in last year's Pink Book, the discrepancy remained considerably smaller than the corresponding balancing items published in the late 1980s. The volatility of the quarterly net statistical discrepancy suggests, however, that gross errors and omissions remain significant (see the chart).

Balancing item: annual and quarterly



The United Kingdom is not unique in having such a statistical discrepancy. The annual report of the International Monetary Fund's (IMF's) balance of payments statistics committee, published in April, highlighted the problem of measuring a balance of payments in a world of increasingly free capital movements. Between 1990 and 1992, there was a recorded deficit in the world current account of around \$100 billion a year; in the same period, the world had a recorded excess of capital inflows over outflows of between \$80 billion and \$150 billion a year.

Both at a global and European level, efforts are being made to improve the quality and comparability of balance of payments data.

At a world level, in 1992 the IMF created a balance of payments statistics committee to take forward the recommendations contained in its studies into current and capital account discrepancies. One of that committee's priorities has been to improve the data on portfolio investment. The capital account study had revealed serious

problems in the measurement of transactions flows and in the associated stock and investment income estimates. As a practical step forward, it had recommended a benchmark portfolio investment survey co-ordinated by the Fund. The committee has set up a task force to prepare for such a co-ordinated survey of assets (and if feasible, liabilities) at the end of 1997. The Central Statistical Office (CSO) and the Bank will both be represented on the task force.

For the participating countries, a comprehensive benchmark survey of assets should improve the quality of outward portfolio investment stock data, and so investment income data. In addition, the Bank's experience with benchmark surveys—such as the recent survey of gilts holdings⁽¹⁾—suggests that the knowledge gained can help to improve the coverage of transactions data by correcting persistent reporting errors. A co-ordinated survey across countries, providing a breakdown of assets by the country of residence of the debtor, should bring additional benefits to the participating countries: by exchanging comparable data (so far as confidentiality constraints permit), participants should be able to improve their estimates of non-resident holdings of their liabilities (inward portfolio investment)—even if the survey does not set out to cover inward investment.

The survey should help to reduce the worldwide discrepancy on the portfolio investment account, and encourage a more consistent approach between countries, not only for the treatment of stock data but also for transactions data. It should also help spread best practice; and comparison of its results may well highlight bilateral discrepancies. But there will clearly be costs both for the compilers and reporters, and these will need to be contained.

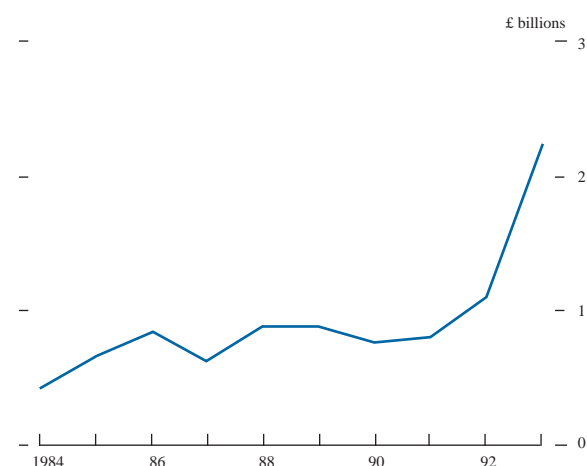
In Europe, a European Monetary Institute (EMI) task force on balance of payments capital flows and stocks is reviewing the methods used by European balance of payments compilers. The objective is to produce meaningful aggregates for the European Union, based on the method set out in the fifth edition of the IMF balance of payments manual. Where difficulties arise over how to apply the IMF method, the task force is considering a standard European approach. The Bank and CSO are again both represented on the task force.

The Bank is contributing to this work particularly in the area of portfolio investment. To help European compilers, it has established a database of financial terminology which includes descriptions of different types of instrument and sets out how they should be treated in the balance of payments accounts. The database combines capital market knowledge with balance of payments method: it is intended as a practical aid to the work of European balance of payments compilers and a stimulus to greater consistency of approach. It has been created primarily for European compilers, but interest has also been expressed elsewhere. Although the Bank provides recommendations on the appropriate treatment of the instruments covered, the final decisions are made by the task force.⁽²⁾

(1) Details of the survey were included in an article on developments in the gilt-edged market in 1993 in the February *Bulletin*, pages 98–102.

(2) A copy of an article describing the Bank's database (originally published in the IMF's balance of payments newsletter) is available from the Balance of Payments Statistics Group, Monetary and Financial Statistics Division, Bank of England.

Chart 5
Banks: portfolio investment income net of funding costs^(a)



(a) Source: British Invisibles 'City Table' 1994.

Invisibles' 1994 City Table.⁽¹⁾ They show a very sharp increase in banks' net earnings from portfolio investment in 1993; since 1991, these earnings have now almost tripled to £2.2 billion. Although the method used to produce the data could usefully be refined further, the underlying message from the figures appears clear: that the UK banks' funding of longer-term assets with short-term liabilities had a significant beneficial effect on the current account position in 1993.

Estimates for 1994 H1 put net investment income at £4.4 billion. A main factor behind this strong performance was the recovery in UK direct investment earnings. Net earnings of £5.4 billion on direct investments were only £0.8 billion below the total for 1993 as a whole; this result probably reflected economic recovery in foreign markets. UK banks have continued to report net interest and dividend receipts and, as in 1993, net receipts on interest rate swaps.

Capital gains and full rates of return

Table F sets out estimated investment income and full rates of return in recent years. The investment income rate of

Table F
Estimated investment income^(a) and full^(b) rates of return on identified assets and liabilities

Percentage points

	Assets									
	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	II	Full	II	Full	II	Full	II	Full	II	Full
1989	7.7	17.4	3.3	18.7	13.4	11.9	8.1	17.3	12.6	13.7
1990	8.7	-5.4	4.1	-20.2	12.8	2.5	9.3	-4.5	13.8	14.2
1991	8.1	10.0	3.8	13.7	10.1	6.8	9.8	8.6	15.3	10.3
1992	5.9	18.1	4.2	15.9	8.9	16.7	6.0	21.3	11.1	6.5
1993	5.4	8.4	3.8	12.0	9.7	12.9	5.7	5.8	7.4	8.4

	Liabilities									
	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	II	Full	II	Full	II	Full	II	Full	II	Full
1989	7.8	16.9	5.6	18.2	9.3	9.4	7.8	18.2	11.3	10.0
1990	8.5	-1.0	6.7	-3.9	6.2	-4.8	9.0	-4.1	12.9	12.6
1991	8.1	8.8	6.2	13.5	3.8	1.4	9.3	8.4	13.7	10.9
1992	5.6	16.5	5.1	16.1	4.2	-1.5	5.6	21.3	9.2	7.1
1993	5.2	6.7	4.0	12.6	8.0	7.7	5.4	4.9	6.1	6.4

(a) II earnings as a percentage of the stock.

(b) II earnings plus stock revaluations as a percentage of the stock.

return is calculated by taking earnings as a percentage of the stock of investment. The full rate of return includes investment income earnings plus any capital gains, again expressed as a percentage of the stock. In 1993, the full rates of return on all assets declined significantly; they had been unusually high in 1992 because the depreciation of sterling that autumn had boosted the sterling value of foreign currency assets and liabilities. Over the last five years, the investment income rates of return for total assets and liabilities have proved remarkably similar.

Table F also highlights the recent tendency for income returns on UK portfolio investment liabilities to be higher than those on assets. Among other factors, this may reflect the preference on the part of UK investors for lower-earning capital-uncertain portfolio investments. Over a long period, however, the full rates of return on portfolio assets and liabilities have been similar, implying that the capital gain on assets has been greater than that on liabilities. In an efficient market, the expected full rates of return, expressed in sterling, should be equal at the margin.

(1) Banks' portfolio investment funding costs are not directly reported and had to be imputed. The method used was set in the press release issued when the City Table was published. Essentially, the stock of investment to be funded is allocated between banks' own foreign currency capital, securitised borrowing from overseas and a residual amount. Capital is regarded as interest-free; interest on securitised borrowing is estimated by the Bank; and the rate of interest applied to the residual amounts is assumed to be equal to the implied rate of interest on banks' total foreign currency borrowing and deposit liabilities to overseas residents.